Davis Polk

SEC adopts new rules and amendments that increase regulation of private fund advisers

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The SEC's amendments include new requirements related to quarterly statements, private fund audits, adviser-led secondaries, restricted activities, preferential treatment and annual reviews under Rule 206(4)-7.

On August 23, 2023, the SEC voted to adopt long-awaited new rules and amendments under the Investment Advisers Act of 1940 (Advisers Act). The SEC noted that the amendments are designed in part to increase investors' visibility into certain adviser practices, and to address adviser practices that can potentially lead to investor harm. As adopted, the new rules and amendments significantly increase regulatory compliance obligations of private fund advisers. The primary elements of the amendments, as compared to the SEC's original proposal in February 2022, are set out below:

	Proposed rule	Final rule
Quarterly statements[1]	Within 45 days after each calendar quarter end, registered private fund advisers would be required to circulate a quarterly statement to private fund investors, including the following: – **Fees and expenses:** Advisers would need to disclose the following information in a table format: ▪ A detailed accounting of all compensation, fees and other amounts allocated or paid to the adviser or any of its related persons by the private fund during the reporting period (e.g., management, advisory, subadvisory or similar fees or payments, and performance-based compensation) ▪ A detailed accounting of all fund fees and expenses paid by the private fund during the reporting period (e.g., organizational, accounting, legal, administration, audit, tax, due diligence and travel expenses) ▪ The amount of any offsets or rebates carried forward during the reporting period to subsequent quarterly periods to reduce future payments or allocations to the adviser or its related persons	The quarterly statement requirement was adopted substantially as proposed with certain modifications including: – Provided an exception for "securitized asset funds" which is defined as "any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders." – Modified the timeframe for distribution of the quarterly statements to: ▪ For private funds that are not funds of funds, within: (a) 45 days after the end of the first three fiscal quarters of each fiscal year, and (b) 90 days after the end of each fiscal year. ▪ For private funds that are funds of funds, within: (a) 75 days after the end of the first three fiscal quarters of each fiscal year, and (b) 120 days after the end of each fiscal year.

– **Portfolio investment-level disclosure:** Advisers would need to disclose the following information in a table format: ▪ A detailed accounting of all portfolio investment compensation allocated or paid by each “covered portfolio investment” during the reporting period, including origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees or payments by the covered portfolio investment to the investment adviser or any of its related persons ▪ The private fund’s ownership percentage of each such “covered portfolio investment” as of the end of the reporting period	– Deleted the requirement to disclose, in the portfolio investment-level disclosure table, a private fund’s ownership percentage of each “covered portfolio investment” as of the end of the reporting period.

– **Calculations and cross-references to organizational and offering documents:** Advisers would need to provide prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers and offsets are calculated, as well as cross-references to the relevant sections of the private fund's organizational and offering documents that set forth the calculation methodology.	The calculation and cross-reference requirements were adopted substantially as proposed.

– **Performance disclosure:** Advisers would need to include standardized performance, including prominent disclosure of the criteria used and assumptions made in calculating the performance; the SEC has proposed a different approach for liquid and illiquid funds: ▪ An adviser to a liquid fund (as defined below) would need to show performance based on net total return on an annual basis since the fund's inception, over prescribed time periods and on a quarterly basis for the current year. ▪ An adviser to an illiquid fund (as defined below)] would need to show performance based on the internal rate of return and a multiple of invested capital (computed without the impact of any fund-level subscription facilities). The SEC expressed its view that subscription	As adopted, the performance disclosure requirement was modified from the proposed version to: – Modify the timeframe for a liquid fund's annual performance disclosure to each fiscal year since inception or **over the past 10 fiscal years, whichever is shorter**. – Clarify that an illiquid fund's performance disclosure must be computed **with and** without the impact of any fund-level subscription facilities.

	– Under the proposed rule, an "illiquid fund" was defined as "a private fund that: (i) has a limited life; (ii) does not continuously raise capital; (iii) is not required to redeem interests upon an investor's request; (iv) has as a predominant operating strategy the return of the proceeds from disposition of investments to investors; (v) has limited opportunities, if any, for investors to withdraw before termination of the fund; and (vi) does not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments." – Under the proposed rule, a "liquid fund" was defined as "a private fund that is not an illiquid fund."	– As adopted, the definition of an "illiquid fund" was modified to retain only clauses (iii) and (v) of the definition in the proposed rule. – The definition of a "liquid fund" was not modified from the proposed version.
Private fund audits[2]	Under the proposed rule, registered advisers to private funds (including subadvisers) would need to cause the private funds to undergo an audit by an independent public accountant at least annually and upon liquidation. The audited financial statements would need to be distributed to investors "promptly" following completion of the audit. The SEC did not provide a specific definition of "promptly" for these purposes.	As adopted, the private fund audit requirement was modified from the proposed version to: – Provide an exception for securitized asset funds (as defined above); and – Align the audit requirement with the audit exception of the custody rule under Rule 206(4)-2.

Adviser-led secondaries[3]	Registered private fund advisers would need to obtain a fairness opinion from an independent opinion provider in connection with certain adviser-led secondary transactions where such adviser offers fund investors the option (i) to sell their interests in the private fund or (ii) to exchange them for new interests in another vehicle advised by the adviser. The adviser would also need to prepare a written summary of any material business relationships with the independent opinion provider within the past two years. Such written summary and the fairness opinion would need to be distributed to investors in the private fund prior to the closing of the transaction.	As adopted, the requirements regarding adviser-led secondary transactions were modified from the proposed version to: – Provide an exception for securitized asset funds; – Clarify that an adviser must obtain and distribute a fairness opinion **or a "valuation opinion,"** which is defined as "a written opinion stating the value (as a single amount or a range) of any assets being sold as part of an adviser-led secondary transaction." – Clarify the timing of distribution of the written summary of material business relationships with the independent opinion provider, and the fairness opinion or valuation opinion, which must be distributed to investors in the private fund prior to the due date of the "election form" (as defined below) in respect of the adviser-led secondary transaction. An "election form" is defined as "a written solicitation distributed by, or on behalf of, the adviser or any related person requesting private fund investors to make a binding election to participate in an adviser-led secondary transaction."

Restricted activities[4]	This proposal would prohibit private fund advisers from engaging in certain activities and practices that are "contrary to the public interest and the protection of investors," including: – Charging certain fees and expenses to a private fund or portfolio investment, including accelerated monitoring fees; fees or expenses associated with an examination or investigation of the adviser or its related persons by governmental or regulatory authorities; regulatory or compliance expenses or fees of the adviser or its related persons; or fees and expenses related to a portfolio investment on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment – Reducing the amount of any adviser clawback by the amount of certain taxes – Seeking reimbursement, indemnification, exculpation or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence or recklessness in providing services to the private fund – Borrowing money, securities, or other fund assets, or receiving an extension of credit, from a private fund client	As adopted, the provisions regarding restricted activities were modified from the proposed version to: – Provide an exception for securitized asset funds; – Delete the restriction on seeking reimbursement, indemnification, exculpation or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence or recklessness in providing services to the private fund; – Delete the restriction on charging a portfolio investment for monitoring, servicing, consulting or other fees in respect of services that the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment; – Clarify that certain activities that were strictly prohibited under the proposed rule may be permissible provided that the adviser complies with certain conditions, including: ▪ Advisers may charge or allocate to a private fund fees or expenses related to investigations of the adviser by a regulatory or governmental authority only with consent from a majority in interest of fund investors not related to the adviser; *provided that*, fees or expenses related to an investigation that results in a sanction under the Advisers Act may not be allocated to a private fund. ▪ Advisers may charge or allocate compliance and examination expenses to a private fund only with written notice, including the dollar amount of the expense, within 45 days after the end of the fiscal quarter in which the charge occurs. ▪ Advisers may not reduce clawback by the amount of any actual, potential or hypothetical taxes, unless the adviser provides written notice of the pre-tax and post-tax dollar amount of the clawback to investors within 45 days after the end of the fiscal quarter in which the clawback occurs. ▪ Advisers may not charge or allocate fees or expenses related to a portfolio investment on a non-pro rata basis unless (i) the charge or allocation is fair and equitable under the circumstances and (ii) prior to charging or allocating the non-pro rata fee or expense to a private fund, the adviser distributes to each investor a written notice of the non-pro rata charge or allocation and a

Preferential treatment/ side letters[5]	Private fund advisers would not be permitted to provide preferential terms to certain investors regarding redemptions or information about portfolio holdings or exposures (e.g., through side letters) that the adviser reasonably expects to have a material negative effect on other investors; this provision would also apply with respect to investors in a "substantially similar pool of assets." Private fund advisers would also be prohibited from providing other preferential terms unless the adviser disclosed such terms in writing to current and prospective investors.	As adopted, the provisions regarding preferential treatment were modified from the proposed version to: – Provide an exception for securitized asset funds; – Provide exceptions for: ▪ preferential terms regarding redemptions if such redemption ability is required under applicable laws or the adviser has offered the same redemption ability to all other existing investors, and to future investors, in the private fund and any similar pool of assets. ▪ preferential terms regarding information on portfolio holdings or exposures if the adviser offers such information to all other existing investors in the private fund and any similar pool of assets at the same time or substantially the same time; – Clarify that, with respect to the requirement to provide written notice to current and prospective investors regarding preferential treatment to other investors in a private fund: ▪ Current investors – in addition to the annual written notice to current investors regarding preferential treatment to investors in the same private fund, the adviser must also distribute the written notice: For an illiquid fund, as soon as reasonably practicable following the end of the private fund's fundraising period; and For a liquid fund, as soon as reasonably practicable following the investor's investment in the private fund; ▪ Prospective investors – the requirement for advance written notice to prospective investors was narrowed to information regarding "preferential treatment **related to any material economic terms"** that is provided to other investors in the same private fund. – Provide legacy status and certain exceptions for contractual agreements entered into prior to the compliance date.

Books and records[6]	The proposal would amend the books and records rule under the Advisers Act to require advisers to retain records related to the proposed rules.	The amendment to the books and records rule was adopted substantially as proposed.
Compliance rule[7]	The proposal would amend the compliance rule under the Advisers Act such that all SEC-registered investment advisers would be required to document their annual review in writing. The SEC did not prescribe any elements regarding what must be a part of the written review and intends for advisers to have flexibility with respect to how they satisfy this requirement.	The amendment to the compliance rule was adopted substantially as proposed.

The compliance date for the quarterly statement and private fund audit requirements will be 18 months after publication in the Federal Register. For the requirements regarding adviser-led secondary transactions, restricted activities and preferential treatment, the compliance dates will be: (a) for advisers with $1.5 billion or more in private fund assets under management, 12 months after publication in the Federal Register and (b) for advisers with less than $1.5 billion in private fund assets under management, 18 months after publication in the Federal Register. The compliance date for the amendment to the compliance rule under the Advisers Act will be 60 days after publication in the Federal Register.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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1 The quarterly statement requirement applies to registered investment advisers to private funds only.

2 The audit requirement applies to registered investment advisers to private funds only.

3 The adviser-led secondaries requirement applies to registered investment advisers to private funds only.

4 The restricted activities requirement applies to all advisers to private funds (including registered investment advisers and exempt reporting advisers).

5 The preferential treatment requirement applies to all advisers to private funds (including registered investment advisers and exempt reporting advisers).

6 The Books and Records Rule applies to all registered investment advisers.

7 The Compliance Rule applies to all registered investment advisers with respect to all clients.